

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

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HPLevine, ID# 62-09574

date: 10/20/99

to: Chief, Customer Service  
Attention: Eric Ruf

from: District Counsel, Kentucky-Tennessee District, Nashville

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subject: Applicability of mark to market to security traders

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ISSUES:

1. Do securities "day traders" qualify to elect the mark to market method of accounting?
2. If "day traders" qualify and elect the mark to market method of accounting, how are income and expenses accounted for?
3. How does the Internal Revenue Service reconcile information returns with income tax returns filed by securities "day traders" who qualify for and elect the mark to market method of accounting?

### CONCLUSIONS:

1. True securities "day traders" can qualify to elect the mark to market method of accounting if they are engaged in the trade or business as securities traders.

2. If "day traders" qualify and elect the mark to market method of accounting, income and expenses are accounted for on Schedule C as ordinary income and deductions although the taxpayer will not be liable for self-employment tax. To the extent that the securities are excepted from mark-to-market as investments, they will be reported on Schedule D.

3. The Internal Revenue Service may or may not be able to reconcile information returns with income tax returns filed by securities "day traders" who qualify for and elect the mark to market method of accounting depending on whether all of their activities are related to day trading. Although IRP was intended to identify taxpayers who filed incorrect returns, no information returns will be required in establishing the mark-to-market transactions which may require the Internal Revenue Service to establish alternative means of identifying those taxpayers such as by activity code.

### FACTS AND DISCUSSION:

I.R.C. §§ 475(e) and (f) were added by § 1001(b) of the Taxpayer Relief Act of 1997 to allow securities traders to elect mark-to-market accounting. These provisions were effective for taxable years ending after August 5, 1997, the date of enactment.<sup>1</sup>

A securities trader eligible to elect mark-to-mark accounting is a person engaged in the trade or business as a trader in securities. I.R.C. § 475(f)(1). You ask whether a "day trader" can qualify as a securities trader who can elect

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<sup>1</sup> By electing mark-to-market accounting, a securities trader recognizes gain or loss on a security at the close of the tax year as if the security were sold for its fair market value. The gain or loss will be ordinary, where it would otherwise be capital. Swartz v. Commissioner, 876 F.2d 657 (8<sup>th</sup> Cir. 1989); Myers v. Commissioner, T.C. Memo. 1994-529. The irony of a "day trader" as a trader in securities is that although mark-to-market method of accounting can be elected, since the securities are generally not held overnight, few securities in reality will be marked to market and the primary benefit will be ordinary gain or loss treatment.

mark-to-market accounting. A "day trader" as we understand that description is a person who trades daily in securities, attempting to profit in daily price fluctuations.<sup>2</sup>

In order to be eligible to mark its securities to market as a securities trader, the person must be engaged in that activity as a trade or business. Whether a person is engaged in a trade or business is made on the basis of all of the facts and circumstances. Commissioner v. Groetzinger, 480 U.S. 23 (1987); Higgins v. Commissioner, 312 U.S. 212 (1941); and Mayer v. Commissioner, T.C. Memo. 1994-209. In this regard, the test focuses on the continuity and regularity of the activity and whether the primary purpose for engaging in the activity was for profit or income. To the contrary, a sporadic activity, a hobby or an amusement diversion will not qualify as being engaged in a trade or business. See also Snvder v. Commissioner, 295 U.S. 134 (1935), where the court held that a taxpayer seeking merely to increase his stock holdings was not engaged in a trade or business. The Snvder court drew a distinction between an active trader and an investor. See also Mayer v. Commissioner, *supra*.

Management of securities investments are always the work of an investor notwithstanding the scope of the activities. Id. Managing and preserving one's own estate, even full-time, is not a trade or business. Id. Factors considered by the court in determining whether a taxpayer who manages his own investments is in the trade or business as a securities trader include: (1) the taxpayer's investment intent; (2) the nature of the income to be derived from the activity; and (3) the frequency, extent and regularity of the taxpayer's securities transactions. Id.; Moller v. United States, 721 F.2d 810, 813 (Fed. Cir. 1983).

In weighing the factors noted above, the courts have used the following two standards which must both be met. A taxpayer's trading activities must be substantial in number of trades and/or dollar amount to constitute a trade or business. Mayer v. Commissioner, *supra*; King v. Commissioner, 89 T.C. 458-59 (1987). The taxpayer must also be attempting to profit from the fluctuations in the daily market movements and to profit from the short-term changes rather than profit from long-term appreciation. Mayer v. Commissioner, *supra*. In this regard, the courts look at whether the securities income is principally derived from the frequent sale of securities rather than

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<sup>2</sup> A national newspaper reported on September 17, 1999, that the SEC estimates that there are less than 7,000 day traders.

interest, dividends or long-term appreciation. Id.<sup>3</sup>

From what we understand the definition of a "day trader" to be, a "day trader" will be engaged in a trade or business where the trading is substantial, that is, continuous and regular. The other requirement should be satisfied since the "day trader" attempts to profit by daily or short-term price fluctuations and may be limited to the extent that securities can be held overnight. Since the "day trader" seeks to profit by the short-term fluctuations and not by appreciation and long-term growth as would be the case of an investor, then the "day trader" would be engaged in a trade or business of securities trader.<sup>4</sup>

The procedures for traders in securities to elect to use the mark-to-market accounting method were recently announced in Rev. Proc. 99-17, 1999-7 IRB 1. Rev. Proc. 99-17, 1999-7 IRB 1 contains procedures for: (1) elections for tax years for which the original return was filed before March 18, 1999; (2) elections for other tax years beginning January 1, 1999; and (3)

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<sup>3</sup> It should be easier for a securities trader to establish that he/she was engaged in the trade or business for mark-to-market election purposes than for I.R.C. § 162 purposes since under the regulations, the securities trader is required to identify those securities held for purposes other than a trade or business and therefore, the securities trader may have dual purposes instead of one primary purpose. However, with the enactment of the mark-to-market election, it is possible that the taxpayer can now be engaged in two separate activities with the possibility that some expenses will be deductible under I.R.C. § 162 and others only as itemized deductions under I.R.C. § 212 as incurred for the production of income. In this regard, see Maver v. Commissioner, *supra*, where significant findings of the court in determining that the taxpayer was not a trader in securities were based on analyses of the taxpayer's total stock transactions, holding periods and source and type of income.

<sup>4</sup> Although under the commonly recognized meaning of the "day trader" term, the securities trader should generally be in the trade or business and therefore allowed to use the mark-to-market method of accounting, we caution on attempting to create general classes of taxpayers with an imprecise definition such as "day trader" since that term is subject to interpretation and may lead to inconsistent results. Rather, it may be better practice in any responses that you provide to self-define the term for purposes of your response (such as by defining "day traders" as persons who hold securities short-term attempting to profit in daily market fluctuations and not as investments for interest or dividend income or for appreciation).

elections for years beginning after 1998. Since mark-to-market is a method of accounting, consent of the Commissioner is required. The consent is obtained by filing Form 3115 during the taxable year in which the taxpayer desires to make the change. An I.R.C. § 481(a) adjustment is necessary to prevent the duplication or omission of income caused by the change of the method of accounting from the previous year.

In the Preamble to the proposed Regulations dated January 28, 1999, published in the Federal Register at Volume 64, no. 18, p. 4374, the Internal Revenue Service discussed the proposed regulations and the purpose behind them. As discussed therein, the proposed regulations provided rules for the identification of investment securities as exempt from mark-to-market. In this regard, the securities trader must identify any security held *other* than in connection with the trading business. The purpose behind the identification procedures was to ensure that securities traders did not selectively mark-to-market some securities while exempting others.

The proposed regulations provided a special rule for identifying securities held other than in connection with the electing trader's trading business when the trader also trades other of the same or substantially similar securities. In that instance, the trader is required to hold the non marked-to-market security in a separate, nontrading account maintained by a third party. The security must be identified as exempt from mark-to-market before the close of the day on which the security was acquired. See Proposed Treas. Reg. §§ 1.475(f)-1, 2.

If the taxpayer is engaged in the trade or business as a securities trader and elects the mark-to-market method of accounting, then the taxpayer is required to report income and expenses on Schedule C, which is used by persons engaged in trades or businesses.<sup>5</sup> See for example the instructions to Schedule E, which indicate that Schedule C should be used by a taxpayer in the business of renting personal property if the primary purpose for renting the property is income or profit and the rental activity is engaged in with continuity and regularity. The taxpayer however would also be required to report on Schedule

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<sup>5</sup> The reporting requirements are not seamless for a securities trader who elects mark-to-market and reports income and expenses on Schedule C. Schedule C profits generally flow to Schedule SE for self-employment reporting although self-employment tax does not apply since the sale of a capital asset is involved and the profit or loss is ordinary only because of the mark-to-market election. I.R.C. § 475(f)(1)(D).

D those securities that are excepted from mark-to-market accounting as being held for investment.<sup>6</sup>

You are correct that the election to the mark-to-market method for a securities trader may make it more difficult for the Internal Revenue Service to reconcile the information returns with the income tax returns. No information returns will be required for gain or loss recognized by marking the security to market itself. I.R.C. § 6045.<sup>7</sup>

IRM 4(14)45.2(25) contains instructions for working IRP cases involving proceeds from the sale of securities. Generally, the Form 1099-B is directly compared to Schedule D to determine if discrepancies exist. If so, the Internal Revenue Service will make such further informal or examination contacts as necessary to reconcile the returns or make an adjustment. In this regard, the IRM anticipates that on occasion, the net gain or loss will be reported directly on the Form 1040. IRM 4(14)45.2(25).

In any event, we do not believe that the Internal Revenue Service ever envisioned that the IRP program would result in complete matching of returns. In this regard, IRM 4(14)12(1) indicates that IRP is an effort to identify taxpayers who have filed incorrect returns or have failed to file returns. It is contemplated that tax returns that do not match the data reported on the information returns will be identified for further screening. IRM 4(14)12(6). As a further example, IRM 4(14)45.2(26), which pertains to information returns reporting bartering income, indicates that there are five separate forms or schedules where the bartering income may be reported. Similarly, if all gross receipts from securities transactions are reported on Schedule C or D, then the Internal Revenue Service may be able to match the information returns to the tax return. If not, then the reconciliation and/or adjustment protocol will be followed.

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<sup>6</sup> There will be a presumption that all securities purchased by a trader in securities are subject to the mark-to-market election. The taxpayer must establish otherwise by clear and convincing evidence. I.R.C. § 475(f)(1)(B)(i). See also Preamble to the proposed Regulations dated January 28, 1999; Proposed Treas. Reg. § 1.475(f)-2(a). This requires at a minimum same day identification and where similar securities are held for both purposes, the requirement that the investment security be held in a separate, nontrading account maintained with a third party. Proposed Treas. Reg. §§ 1.475(f)-2(a), (d).

<sup>7</sup> As noted earlier, this may not be a problem for "day traders" since the extent that they will hold stocks overnight and at the end of the taxable year will be limited.

We are seeking post-review from our National Office because of the technical nature of the questions that you raised and since they implicate interpretive and policy considerations. We will follow-up with their response once received.

Attached is a client survey which we request that you consider completing. The client survey is an attempt to measure your satisfaction with the service provided by this office. We expect to be able to use your response to improve the services that we provide to you.

Please contact the undersigned at (615) 250-5072 if you have any questions.

JAMES E. KEETON, JR.  
District Counsel

By:

HOWARD P. LEVINE  
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